June 10, 2016

RBC WEALTH MANAGEMENT

Global Insight

Weekly

A closer look

Brexit or Bremain: The plot thickens

Frédérique Carrier – London

With the Brexit drama's final act nearing its climax, an unexpected denouement could be taking shape while a fog of uncertainty continues to descend.

With less than a fortnight until the U.K.'s landmark referendum on EU membership, polls seem to suggest the "Remain" campaign to stay in the EU might be losing its narrow lead over the "Leave" camp. Remain is still our base-case forecast, but the race is more of a nail biter than expected.

It seemed at the beginning of the year that there were just two possible outcomes; either the status quo with the U.K. opting to stay in the EU, or a wholesale change to leave. However, a new potential outcome is now rearing its head: the possibility of a narrow Remain vote.

Under a narrow Remain scenario, the probability of a U.K. leadership crisis grows, in our view, as the EU debate has exposed rifts in the ruling Conservative Party. In such a case, Prime Minister David Cameron could come under pressure to step down, according to some Conservatives who advocate Brexit.

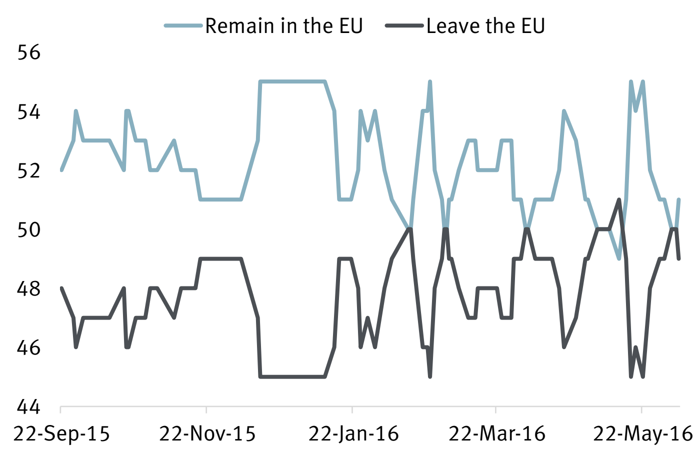
For the U.K. economy and markets, political uncertainty and government gridlock could be unsettling at a time when fiscal discipline is still very much needed.

Cameron's leadership could face even more questions should the U.K. vote to exit the EU, as backbenchers could attempt to force him out, according to press reports citing officials on both sides of the Brexit issue.

A Leave vote would also likely raise concerns about the cohesion of the EU. Opposition parties in France and the Netherlands are already promising to renegotiate membership terms if they win power, while popular demand for EU membership referendums is growing.

Brexit vote too close to call

U.K.'s EU referendum voting intentions: average from last six polls (%)



Source - RBC Capital Markets, What UK Thinks website; data through 6/6/16

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 6/10/16 market close, EST (unless otherwise stated).
For important and required non-U.S. analyst disclosures, see Page 6.

RBC Wealth Management

Peering into the economic fog

Uncertainty around the referendum might be partially responsible for the slowdown in the U.K. economy, but we believe it does not tell the full story.

RBC Capital Markets, LLC's Senior U.K. Economist Sam Hill points out that the economy has been slowly losing momentum since Q2 2014 along with other developed countries. He calculates that just under half of the slowdown this year can be attributed to referendum fears and uncertainty holding back investment and spending.

As such, should the U.K. vote to Remain, whether by a narrow or wide margin, he only expects a modest rebound in the economy as uncertainty lifts (see upper chart).

While we believe the U.K. would be able to reinvent itself in the long term should it vote to Leave, uncertainty in the short-to-medium term could cause the economy to contract by 2%–4% over a 2–3 year horizon, Hill estimates.

Widespread fallout

In our previous *Brexit or Bremain* report, we highlighted that the repercussions of a Leave vote would ripple beyond the U.K.'s shores.

With just over 7% of S&P 500 revenues coming from the U.K. and Europe, a Brexit vote may seem inconsequential to North America. But a setback in U.K. and European domestic demand due to uncertainty and potentially long negotiations following a Leave vote would likely dent the profitability of U.S. businesses with British and perhaps European operations.

For European equity markets, an initial negative knee-jerk reaction could occur as a Leave vote does not seem fully discounted at current price levels. We have been advocating a bias towards domestic cyclicals in European portfolios. A Brexit vote would see us reduce this bias.

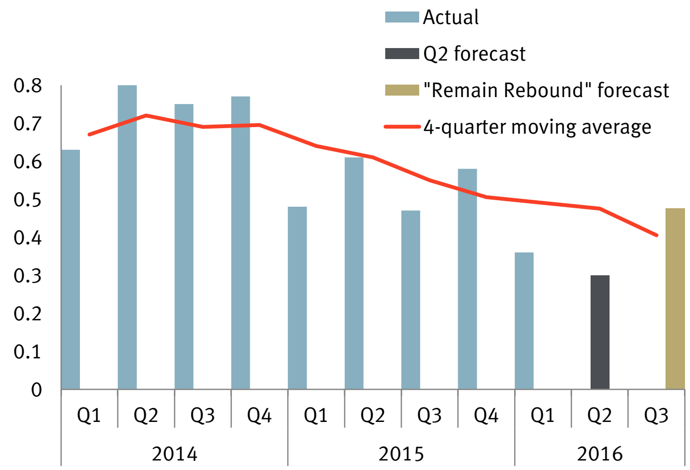
In the U.K., we would expect a Leave vote to usher in higher fixed income volatility as a tug-of-war ensues between the Bank of England loosening policy and Gilts sales by foreign investors. We would also expect the pound to weaken, which would be positive for U.K.-based exporters, particularly companies with U.S. dollar exposure. Companies geared to the domestic economy and those that depend on EU regulation (banks and airlines) are most at risk, in our view.

With a Remain vote, we would expect a modest relief rally in financial markets. For U.K. equities, we believe domestic cyclicals and banks would be the main beneficiaries.

With less than two weeks before the referendum, swings in opinion are still possible. But once the Brexit vote is out of the way, regardless of the outcome, financial markets will likely turn to the next big event—the U.S. presidential election.

The economic slowdown started two years ago

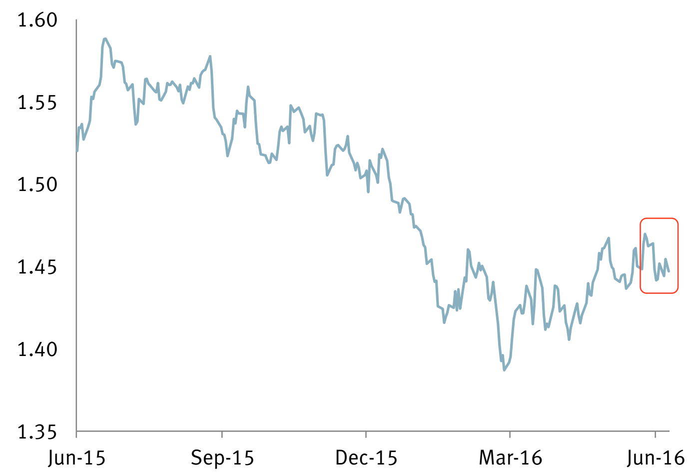
U.K. GDP growth (q/q %)



Source - RBC Capital Markets (forecast data), Haver Analytics

Sterling has pulled back since late May

GBPUSD cross rate: price of 1 pound sterling in U.S. dollars



Source - RBC Wealth Management, Bloomberg; data through 6/9/16

This report is for information purposes only and is not intended to take a position on the EU referendum. RBC adopts a neutral stance on the outcome of the EU referendum.

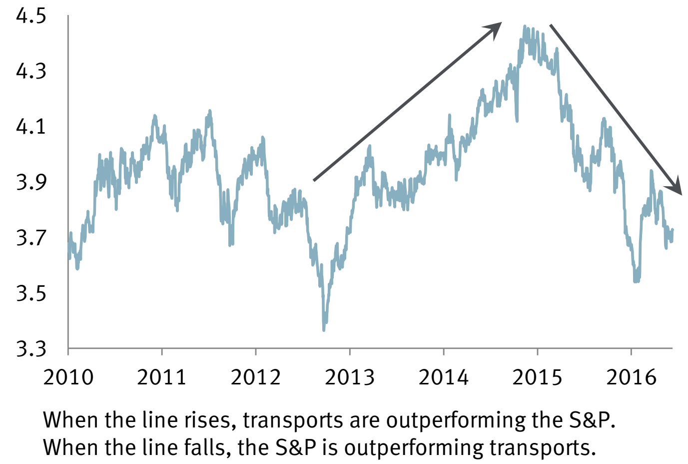
United States

Kelly Bogdanov – San Francisco

- **Negative interest rate** policies overseas and **expectations the Fed will remain on hold** this summer continued to tug U.S. yields lower. And to a lesser extent, the **World Bank's reduction of its 2016 global GDP growth forecast** to 2.4% from 2.9% may have also held back government bond yields. If the new, lower forecast comes to fruition, it would match last year's subdued global growth rate.
- The 10- and 30-year Treasury yields finished the week near 1.64% and 2.45%, respectively, well above 0.02% and 0.59% for comparable German maturities. The **10-year Treasury yield is only 25 basis points (bps) above its all-time low level** reached in mid-2012 during the European sovereign debt crisis. All of this is occurring amid a flattening U.S. yield curve. The market is now pricing in no chance of a rate hike at the June 15 Fed meeting and an **18% chance at the July meeting**, down from 27% the previous week and 55% before the dismal May jobs report.
- **The S&P 500 ended the week fractionally lower** as investors murmured about the ultralow rate environment. Even though the equity market has bounced forcefully off of the February 11 lows, it has been **unable to break through its all-time high level** reached in May 2015. From our vantage point, **the market is due for a modest pullback**, especially considering we are in the midst of the typically slow summer season and near-term economic and earnings catalysts are lacking.
- **The ho-hum performance of transportation stocks**—often a bellwether for the broader market—**is one reason the S&P 500** and other major indexes **may need to take a breather**. The Dow Jones Transportation Average outperformed for the week, but has lagged the S&P 500 since the February low and going back even further to late 2014 (see chart), the same time the broader market began to stall into a trading range. In our view, **the transports need to get moving and lead** in order for the broader market to decisively break out to new highs.
- **Lackluster earnings prospects are also holding back the equity market**. The 2016 S&P 500 consensus forecast stands at $118.68 per share, up just 1% from 2015 and nearly equivalent to 2014, according to Thomson Reuters I/B/E/S. The 2016 estimate seems achievable to us, if not beatable. **Earnings estimate revisions have been positive lately**, helped along by dollar weakness. The Thomson Reuters **2017 consensus estimate of $135.71 per share seems too high**, in our view, even with the likely rebound in Energy sector earnings. We're more comfortable using $125–$130 as a reasonable estimate range.

Transports are still lagging the broader market

Dow Jones Transportation Average vs. S&P 500 relative performance (TRAN/SPX ratio)



Source - RBC Wealth Management, Bloomberg; data through 6/9/16

Canada

Patrick McAllister & Alana Awad – Toronto

- The **S&P/TSX Composite declined** on broad-based weakness. The **resource sectors** are the **best-performing components** of the market year to date, **followed by the Utilities and Telecom sectors** as sovereign bond yields make new lows.
- The North American crude oil benchmark continues to trade around the $50 per barrel level. **Crude oil has rallied sharply** since the February lows and RBC Capital Markets forecasts **an average price of $57 in 2017**. We expect **capital and operating cost savings** realized over the past two years to exhibit a degree of **persistence**, allowing producers to capture **higher margins** as commodity prices improve.
- The Canadian economy created a **better-than-expected 13,800 jobs** in May. While Canadian employment data is typically lumpy and best analysed by examining trends, **we are encouraged by the strong gain in full-time positions**. The addition of jobs in public administration related to the census may not be repeated, but the strength in the construction and manufacturing sectors was a positive development. While employment in energy-sensitive regions has suffered since 2015, hiring in the rest of the country has continued apace.
- In the **Bank of Canada's semiannual Financial System Review** released on Thursday and the accompanying press conference, Governor Stephen Poloz highlighted an **increase** in the **financial vulnerabilities** present in the **household sector**.

- The **preferred share space** experienced **small gains** during the week. The lack of issuance has been supportive of inflows into secondary issues. Despite lower 5-year bond yields, **credit spreads** continue to **tighten** and we continue to see **inflows into exchange-traded funds** in the space.

Europe

Frédérique Carrier – London

- With **Brexit uncertainty swirling** and the vote just two weeks away, **investors stayed on the sidelines. The STOXX Europe 600 retreated** 2.5% over the week. Fed Chair Janet Yellen's comments signalling the U.S. central bank would likely not hike rates this month following weak U.S. jobs data, Brexit polling volatility, and the kickoff of the European Central Bank's corporate bond-buying programme all conspired to **flatten the futures curves**. Bond yields and inflation expectations fell while the pound retreated against the euro.
- **Telecoms** in both the U.K. and Europe were a **notable underperformer** during the week. The sector has underperformed year to date as relatively full valuations were not supported by improved earnings momentum. Moreover, **M&A efforts** in the U.K. and France have **failed** and **pricing power remains disappointing** in some countries. Yet, the sector is a **core part of investors' portfolios** as it remains **defensive** at an uncertain time and **generous dividends** (some 5% yield) are well covered by cash flow. During the week, **Vodafone** announced it will **merge its New Zealand subsidiary** with the country's leading provider of pay TV services with some 830,000 subscribers. This transaction is in line with the industry trend towards offering customers integrated services (the so-called "quadplay").
- **Banks** was another sector which **suffered**. **However, HSBC** announced it received **regulatory approval** from Brazil's antitrust authority for the long-awaited completion of the **sale of its Brazil business**. This is a positive step in HSBC's goal to **optimise its global network and reduce complexity**. The consensus expects the transaction to prop up the group's common equity Tier 1 ratio by 65 bps, taking it to 12.55%, a level more closely aligned with the sector average.

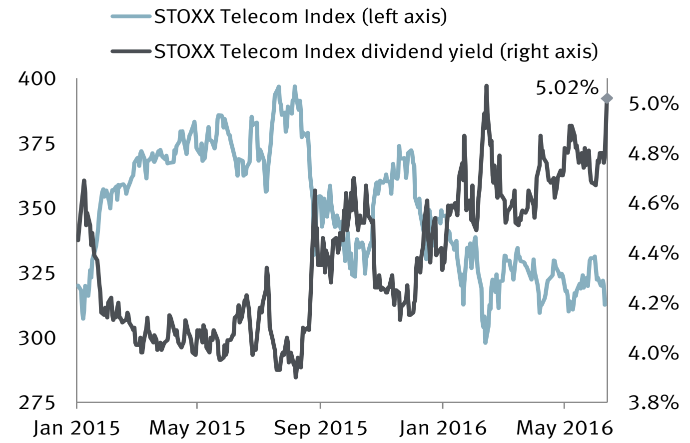
Asia Pacific

Jay Roberts – Hong Kong

- Asian equities generally shrugged off the weak U.S. employment data for May. The **MSCI AC Asia Pacific Index rose** through the week, **helped in part by a weaker dollar**.

European telecom yields are looking attractive

STOXX Europe 600 price and dividend yield



Source - RBC Wealth Management, Bloomberg; data through 6/10/16

- Asian equities had a very weak start to the year, trading down with global equity markets. **The index has moved steadily higher** over the past four months and is up 16% from the February low. Even so, a number of **major indexes**, including those in **Japan, Hong Kong, Singapore, and South Korea**, still trade at **depressed valuations**.
- The **Bank of Korea** unanimously decided to **cut its benchmark rate** by 25 bps to a **new low of 1.25%** in light of relatively low inflation. RBC Capital Markets had been expecting a rate cut for a while and believes that, while the bank retains an easing bias, the **bar is high for another cut this year**. Rather, RBC Capital Markets believes that the government will announce a supplementary budget deficit in coming months. The benchmark **KOSPI Index** was little changed. The index trades at a **price-to-book value multiple of 0.95x, close to its lowest level since the global financial crisis**.
- The **Reserve Bank of New Zealand** (RBNZ) kept its **benchmark rate unchanged** at 2.25%, as forecast. However, a number of forecasters had expected a cut. RBC Capital Markets noted that the statement from the RBNZ highlights the **ongoing conflict** between a **strong housing market** against an **elevated exchange rate** and the **global economic risks**.
- The **kiwi rallied**, capping several weeks of notably strong performance during which the currency rose by 6% against the dollar. However, **RBC Capital Markets forecasts that the RBNZ will cut rates** by 25 bps in August and that NZDUSD, now at 0.709, will decline to 0.65 and 0.6 by the end of 2016 and 2017, respectively. In his statement, **RBNZ Governor Graeme Wheeler** commented that "the **exchange rate is higher than appropriate** given New Zealand's low export commodity prices."

MARKET SCORECARD

Data as of June 10, 2016

Equities (local currency)	Level	1 week	MTD	YTD	12 mos
S&P 500	2,096.07	-0.1%	0.0%	2.6%	-0.4%
Dow Industrials (DJIA)	17,865.34	0.3%	0.4%	2.5%	-0.8%
NASDAQ	4,894.55	-1.0%	-1.1%	-2.3%	-3.6%
Russell 2000	1,163.93	0.0%	0.8%	2.5%	-8.1%
S&P/TSX Comp	14,037.54	-1.3%	-0.2%	7.9%	-5.7%
FTSE All-Share	3,366.91	-1.4%	-1.8%	-2.2%	-9.6%
STOXX Europe 600	332.92	-2.5%	-4.2%	-9.0%	-14.8%
German DAX	9,834.62	-2.7%	-4.2%	-8.5%	-12.7%
Hang Seng	21,042.64	0.5%	1.1%	-4.0%	-21.2%
Shanghai Comp	2,927.16	-0.4%	0.4%	-17.3%	-42.7%
Nikkei 225	16,601.36	-0.2%	-3.7%	-12.8%	-17.2%
India Sensex	26,635.75	-0.8%	-0.1%	2.0%	-0.8%
Singapore Straits Times	2,822.97	0.5%	1.1%	-2.1%	-15.1%
Brazil Ibovespa	49,422.16	-2.4%	2.0%	14.0%	-8.3%
Mexican Bolsa IPC	45,177.50	-1.6%	-0.6%	5.1%	1.3%

Commodities (USD)	Price	1 week	MTD	YTD	12 mos
Gold (spot $/oz)	1,274.62	2.4%	4.9%	20.1%	7.4%
Silver (spot $/oz)	17.33	5.5%	8.3%	25.0%	8.0%
Copper ($/metric ton)	4,500.50	-4.2%	-4.2%	-4.4%	-25.3%
Oil (WTI spot/bbl)	49.07	0.9%	-0.1%	32.5%	-20.1%
Oil (Brent spot/bbl)	50.45	1.6%	1.5%	35.3%	-23.2%
Natural Gas ($/mmBtu)	2.57	7.3%	12.4%	10.1%	-11.0%
Agriculture Index	334.34	3.4%	8.3%	17.9%	14.5%

Govt bonds (bps chg)	Yield	1 week	MTD	YTD	12 mos
U.S. 2-Yr Tsy	0.727%	-4.5	-15.1	-32.1	0.2
U.S. 10-Yr Tsy	1.640%	-6.0	-20.5	-62.9	-84.3
Canada 2-Yr	0.502%	-0.4	-11.2	2.1	-17.9
Canada 10-Yr	1.125%	-5.4	-19.4	-26.9	-78.1
U.K. 2-Yr	0.394%	5.6	-3.8	-25.7	-18.0
U.K. 10-Yr	1.232%	-4.4	-19.7	-72.8	-89.6
Germany 2-Yr	-0.545%	-1.0	-3.1	-20.0	-38.1
Germany 10-Yr	0.020%	-4.8	-11.9	-60.9	-96.1

Currencies	Rate	1 week	MTD	YTD	12 mos
U.S. Dollar Index	94.59	0.6%	-1.4%	-4.1%	-0.1%
CAD/USD	0.78	1.4%	2.6%	8.4%	-3.9%
USD/CAD	1.28	-1.4%	-2.6%	-7.8%	4.1%
EUR/USD	1.13	-1.0%	1.1%	3.6%	-0.6%
GBP/USD	1.43	-1.7%	-1.4%	-3.1%	-8.1%
AUD/USD	0.74	0.2%	2.0%	1.3%	-4.9%
USD/CHF	0.96	-1.2%	-3.0%	-3.8%	3.5%
USD/JPY	106.95	0.4%	-3.4%	-11.0%	-12.8%
EUR/JPY	120.38	-0.6%	-2.3%	-7.9%	-13.4%
EUR/GBP	0.79	0.7%	2.6%	7.0%	8.1%
EUR/CHF	1.09	-2.2%	-1.9%	-0.3%	2.9%
USD/SGD	1.36	0.2%	-1.3%	-4.2%	1.3%
USD/CNY	6.56	0.2%	-0.3%	1.1%	5.7%
USD/BRL	3.42	-2.9%	-5.2%	-13.6%	9.8%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX. Bond yields in local currencies. Copper and Agriculture Index data as of Thursday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:40 pm GMT 6/10/16.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 8.4% return means the Canadian dollar rose 8.4% vs. the U.S. dollar year to date. USD/JPY 106.95 means 1 U.S. dollar will buy 106.95 yen. USD/JPY -11.0% return means the U.S. dollar fell 11.0% vs the yen year to date.

UPCOMING EVENTS

Sun, Jun 12
China Industrial Prod. (6.0% y/y)
China Retail Sales (10.1% y/y)
China Fixed Assets (10.5% y/y)

Tue, Jun 14
China MSCI Decision
Japan Industrial Prod.
Eurozone Industrial Prod.
Eurozone Employment
U.K. CPI (0.4% y/y)

Tue, Jun 14 (cont.)
U.K. RPI
U.S. Retail Sales (0.3% m/m)
U.S. Retail Sales Control (0.3% m/m)

Wed, Jun 15
Eurozone Trade Balance
U.K. Unemployment
U.K. Employment Change
Fed Meeting
U.S. Industrial Prod. (-0.2% m/m)

Wed, Jun 15 (cont.)
Canada Manuf. Sales
Canada Existing-Home Sales

Thu, Jun 16
BoJ Meeting
Eurozone CPI
BoE Meeting & MPC Minutes
ECB Economic Bulletin
U.S. CPI (1.1% y/y, Core 2.2%)

Fri, Jun 17
U.S. Housing Starts (1.15M)
Canada CPI (1.6% y/y, Core 2.0%)

Sun, Jun 19
Japan Exports
Japan Imports

Tues, Jun 21 – Wed, Jun 22
Fed Chair Yellen testifies

Thu, Jun 23
Eurozone Trade Balance

All data reflect Bloomberg consensus forecasts where available

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As of March 31, 2016

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	887	51.78	258	29.09
Hold [Sector Perform]	722	42.15	115	15.93
Sell [Underperform]	104	6.07	8	7.69

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